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December 30, 2002

ORIGINAL

Docket Control  
Arizona Corporation Commission  
1200 W. Washington  
Phoenix, Arizona 85007

RE: ARIZONA PUBLIC SERVICE COMPANY'S REQUEST IN THE MATTER OF THE APPLICATION FOR AN ORDER OR ORDERS AUTHORIZING IT TO ISSUE, INCUR, OR ASSUME EVIDENCES OF LONG-TERM INDEBTEDNESS; TO ACQUIRE A FINANCIAL INTEREST OR INTERESTS IN AN AFFILIATE OR AFFILIATES; TO LEND MONEY TO AN AFFILIATE OR AFFILIATES; AND TO GUARENTEE THE OBLIGATIONS OF AN AFFIIATE OR AFFILIATES PURSUANT TO ACC DOCKET NOS. E-01345A-02-0707.

Dear Sir or Madam:

Pursuant to the Procedural Order dated October 9, 2002, Docket No. E-01345A-02-0707, Arizona Public Service Company is hereby filing the rebuttal testimony of Jack E. Davis, Barbara M. Gomez and Arthur H. Tildesley.

If you or your staff have any questions, please feel free to call me.

Sincerely,

*Jana Van Ness/vld*

Jana Van Ness  
Manager  
Regulatory Compliance

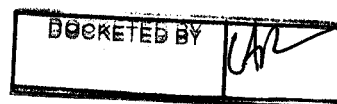
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**REBUTTAL TESTIMONY OF JACK E. DAVIS**

**On Behalf of Arizona Public Service Company**

**Docket No. E-01345A-02-0707**

**December 30, 2002**

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**REBUTTAL TESTIMONY OF JACK E. DAVIS**  
**ON BEHALF OF ARIZONA PUBLIC SERVICE COMPANY**  
**(Docket No. E-01345A-02-0707)**

**I. INTRODUCTION**

**Q. PLEASE STATE YOUR NAME, ADDRESS AND OCCUPATION.**

A. My name is Jack E. Davis. My business address is 400 North Fifth Street, Phoenix, Arizona 85072. I am President and Chief Executive Officer for Arizona Public Service Company ("APS" or "Company"). I am also a President of Pinnacle West Capital Corporation ("PWCC").

**Q. WHAT IS YOUR EDUCATIONAL AND PROFESSIONAL BACKGROUND?**

A. My resume is attached as Appendix A to this testimony.

**Q. DID YOU PREVIOUSLY SUBMIT WRITTEN TESTIMONY IN THIS FINANCING PROCEEDING?**

A. No.

**Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY IN THIS PROCEEDING?**

A. I very much agree with Utilities Division Staff ("Staff") witness John S. Thornton, Jr., and Residential Utility Consumer Office ("RUCO") witness Mary Lee Diaz-Cortez that granting the Application is in the public interest. I will support that conclusion by reminding the Arizona Corporation Commission ("Commission") of the origins of Pinnacle West Energy Corporation ("PWEC") and its intended relationship with Arizona Public Service Company ("APS" or "Company"). I also will defend the financing plan used to pay for PWEC's construction program from the unsupported claims of Panda Gila River, L.P. ("Panda/TECO") witness Susan Abbott. Finally, I wish to discuss the existing

1 regulatory insulation of APS from potential affiliate abuse and explain the APS  
2 position with regard to the Staff's proposed dividend limitation. Such a  
3 limitation is one of the conditions Staff has requested that the Commission adopt  
4 in its approval of the Company's Application.

5  
6 **II. SUMMARY**

7 **Q. COULD YOU PLEASE SUMMARIZE YOUR TESTIMONY?**

8 **A.** In evaluating the public interest criteria discussed by both Mr. Thornton and  
9 APS witness Barbara M. Gomez, as well as other witnesses, the Commission  
10 must consider all of the benefits realized as a result of granting the Application  
11 rather than getting hung up on parsing the various specific terms used in Title  
12 40, Arizona Revised Statutes. And it cannot be forgotten that PWEC was created  
13 as a direct result of, and would never have existed absent, the 1999 APS  
14 Settlement and the Commission's Electric Competition Rules. Its two primary  
15 purposes were to receive the APS generation units divested pursuant to that  
16 Settlement and to construct new generation for APS customers so that these  
17 customers would not be wholly dependent on the vagaries of the wholesale  
18 electric market for reliable and reasonably-priced generation. In this role, PWEC  
19 could also serve as a competitive check on that wholesale market to the long-  
20 term benefit of APS and its customers.

21 The financing plan that PWCC put together was intended to produce the lowest  
22 cost of constructing that generation consistent with the mandated divestiture date  
23 of December 31, 2002. That plan was reviewed and validated by independent  
24 rating agencies. It was working, and it would have continued to work had APS  
25 been allowed to divest its generation to PWEC as was originally agreed to by the  
26 Company and the Commission.

1 APS is subject to intense and overlapping affiliate regulation at both the state  
2 and federal level. That regulation provides significant and explicit "regulatory  
3 insulation" to APS. Indeed, the very existence of this proceeding is a prime  
4 example of that insulation—a fact that some of the witnesses and, unfortunately,  
5 some debt rating agency analysts, choose to ignore.

6 The APS Board of Directors is charged with setting the dividend policies of the  
7 Company. As one of those Directors, I can tell you that we take that  
8 responsibility seriously and would not agree to Staff's proposed dividend  
9 limitation unless we believed it in the interests of both APS and PWCC under  
10 the special and unique circumstances of this case. As proposed by Staff, and  
11 with the clarification suggested by Ms. Barbara Gomez in her Rebuttal  
12 Testimony, it is a condition to the approval of our Application that is acceptable.  
13

14  
15 **III. BENEFITS FROM GRANTING THE APPLICATION**

16 **Q. PANDA/TECO WITNESS ABBOTT URGES THE COMMISSION TO**  
17 **DENY THE APPLICATION. WOULD YOU SUMMARIZE THE**  
18 **REASONS SUCH DENIAL WOULD BE INAPPROPRIATE?**

19 **A.** Yes. Granting the Application, even subject to Staff's conditions, has at least  
20 eight distinct benefits for APS and its customers. The proposed financing would:

- 21 • Avoid a downgrade of APS debt ratings
- 22 • Avoid corresponding increases in the APS cost of capital
- 23 • Strengthen wholesale competition by maintaining PWEC  
24 as a viable competitor in the upcoming Track B  
25 solicitation
- 26 • Preserve the Commission's ability to consider rate base  
treatment of the PWEC assets in the 2003-2004 rate case
- Strengthen investor and rating agency confidence in the  
Commission

- Continue a responsive and responsible regulatory environment
- Preserve the current Track B solicitation process
- Result in settlement of most of the issues in the Track A legal appeals

**Q. HAVE YOU ATTEMPTED TO MATCH THESE BENEFITS TO THE SPECIFIC LANGUAGE IN THE STATUTES AND REGULATIONS CITED BY MR. THORNTON AND MS. GOMEZ?**

**A.** No. I will leave that to the lawyers and these other expert witnesses. To me, all of these criteria are rolled into the public interest standard. Each of the above benefits is clearly in the public interest, and perhaps of more specific concern, in the interest of APS customers. Just as obviously, obtaining all eight of these benefits is all the more beneficial to APS and its customers.

**IV. ORIGIN, PURPOSE AND FINANCING OF PWEC**

**Q. WHY IS PWEC DIFFERENT FROM OTHER MERCHANT GENERATING ENTITIES IN ARIZONA?**

**A.** Unlike Ms. Gomez, I was, in part, responsible for PWEC's creation. And unlike any merchant generator in Arizona (or anywhere else, for that matter), PWEC owed its existence to a Settlement Agreement between APS and the Commission itself. No entity other than PWEC had the right, or even the expectation, of acquiring the Company's generation by December 31, 2002. No merchant generator built its entire business upon the notion that it had a responsibility to plan for and subsequently serve APS customers prior to seeking markets elsewhere.

This was no hypothetical duty. PWEC, and only PWEC, constructed new generation within Metro-Phoenix to help provide the local generation needed to

1 reliably serve the great majority of the Company's customers. Only PWEC  
2 moved quickly to bring in temporary generation during the critical summer  
3 months of 2001—an action costing PWEC many millions of dollars and for  
4 which APS customers were asked to pay nothing. And I personally vetoed a  
5 proposal to sell forward the output of PWEC's plants to California during the  
6 2001 "buying spree" by the California Department of Water Resources. We thus  
7 forewent a potential long-term above-cost contract that might have given PWEC  
8 the basis for independent financing.

9  
10 **Q. COULD NOT PWEC SIMPLY CONTINUE AS AN INDEPENDENT  
MERCHANT ENTITY?**

11 A. Absent the requested financing, it may not continue at all. And PWEC was  
12 never envisioned as or structured to be a start-up merchant venture. That is why  
13 the present intent is to fold the Arizona part of PWEC back into APS. PWEC's  
14 very limited Nevada project (Silverhawk) could continue on with the strong  
15 partnering of the Southern Nevada Water Authority. Silverhawk also has  
16 transmission access to Phoenix and could participate in competitive power  
17 procurements by any of the Arizona utilities, including APS.

18  
19 **Q. WHY WAS PWEC'S CONSTRUCTION FINANCED BY PWCC?**

20 A. You have to remember that APS was going out of the generation business after  
21 the 1999 Settlement, regardless of whether the Electric Competition Rules  
22 survived their ongoing legal challenge by the state's electric cooperatives and  
23 certain consumer groups. It would not have made sense to finance generation at  
24 APS. Indeed, I am sure that some would have contended that any costs incurred  
25 to thereafter transfer such new generation to PWEC were imprudent. And given  
26 the Company's existing Code of Conduct, which barred it from participating in



1 competitive electric activities, including generation, even prior to the scheduled  
2 December 31, 2002 divestiture, we would have had to seek some manner of  
3 variance to do so in any event.

4 The only other entity in the Pinnacle West group having significant financing  
5 capacity was PWCC. Although PWCC has few tangible assets, it had steady  
6 cash flows from APS and SunCor Development Company ("SunCor"), as well  
7 as a successful Marketing and Trading ("M&T") division. Rating agencies, as  
8 well as debt and equity analysts, were willing to accept high levels of PWCC  
9 debt for the short term because of the promise that the debt would eventually be  
10 unified at an operating subsidiary (then envisioned as PWEC) having both the  
11 assets and associated debt of APS' generation. That was to happen by year-end  
12 2002 at the latest, and thus it is no mere coincidence that most of PWCC's  
13 bridge debt comes due in 2003.

14 **Q. WHY DIDN'T PWEC USE PROJECT FINANCING TO SUPPORT**  
15 **NEW CONSTRUCTION?**

16 **A.** The better question is why use such financing if it will be more expensive, less  
17 flexible and unnecessary. Although project financing may have been available  
18 to PWEC without a PWCC guarantee and even without a long-term agreement,  
19 the cost compared with using the Bridge Debt would have been high, and this  
20 higher cost could have hurt APS consumers since they were the primary  
21 intended beneficiaries of PWEC's construction. And I am sure the banks would  
22 have had something quite negative to say about the decision not to sell  
23 PWEC's output to California in 2001. I know they also would not be waiting to  
24 see what the Commission was going to do about rate-basing the PWEC assets  
25 in the next APS rate case. We would be under tremendous pressure to the sell  
26

1 these assets' output, if not the PWEC assets themselves, today regardless of  
2 whether such sales were in the best interest of APS customers.

3  
4 **Q. WAS THE PWCC FINANCING OF THE PWEC ASSETS SUCCESSFUL?**

5 A. Yes. PWCC borrowed some three-quarters of a billion dollars with the  
6 understanding that the bulk of this would be refinanced at the operating  
7 subsidiary level in 2003. After all, at the time, PWEC had an investment grade  
8 rating that it could use post-divestiture. And PWEC fully anticipated being able  
9 to fulfill both its financial and operational role in supporting the unified  
10 generation of APS and PWEC, both of which sets of generation were built to  
11 serve APS customers.

12  
13 **Q. DIDN'T THE DETERIORATION OF THE FINANCIAL MARKETS FOR GENERATION IN 2002 HAVE MORE TO DO WITH PWCC AND PWEC'S DILEMMA THAN THE ABSENCE OF DIVESTITURE?**

14 A. It was certainly a significant factor for PWCC, and I don't mean to  
15 underestimate the importance of the present depressed financial market for  
16 electric generation in general. If the credit markets had remained as they were in  
17 2000 and early to mid-2001, it is possible (although by no means certain) that  
18 PWEC could have obtained refinancing for PWCC's Bridge Debt even with the  
19 limited and undiversified group of generating assets left at PWEC by Decision  
20 No. 65154. This is especially true if the opportunity presented in 2001 to  
21 forward sell these PWEC facilities' output to California had been seized upon  
22 without regard for the consequences to APS' customers. But the financial  
23 markets did change, divestiture did not occur, and PWEC remained true to its  
24 original purpose—a decision for which I do not apologize.  
25  
26

1 V. EXISTING AFFILIATE RESTRICTIONS AND "REGULATORY  
2 INSULATION"

3 Q. STAFF'S RECOMMENDATIONS STRESS THEIR BELIEF THAT  
4 "REGULATORY INSULATION" OF APS SHOULD BE  
5 STRENGTHENED. DOES THIS MEAN THAT SUCH INSULATION  
6 DOES NOT EXIST AT PRESENT?

7 A. No. APS is subject to any number of restrictions that insulate the Company from  
8 the potential of affiliate abuse. The first, most obvious, and in the long run most  
9 effective insulation is this Commission's power to disallow unreasonable or  
10 imprudent costs in setting APS retail rates. Second, the Commission has  
11 imposed a general set of affiliate rules on all utility holding company  
12 organizations above a certain minimal size. Unlike virtually all the other covered  
13 utilities, APS has never received a general waiver of such affiliate rules and just  
14 this December, received its first transaction-specific waiver unrelated to the  
15 1999 Settlement and the Electric Competition Rules. This waiver permitted APS  
16 to provide a back-up line of credit to PWCC. *See* Decision No. 65434  
17 (December 3, 2002). Third, APS has both state and federally-mandated codes of  
18 conduct covering inter-affiliate pricing and inter-affiliate accounting for electric  
19 service affiliates such as APS Energy Services, Inc., PWEC and M&T. The  
20 Commission has also approved Policies & Procedures to implement the state  
21 Code of Conduct. Fourth, the Federal Energy Regulatory Commission has  
22 Standards of Conduct governing specific functions at APS. And this  
23 Commission is presently considering both an expanded state Code of Conduct  
24 filed in response to Decision No. 65154 and a Staff recommendation in Track B  
25 for state Standards of Conduct governing competitive power solicitation.  
26

24 A. DOES THIS APPLICATION PROVIDE EVIDENCE THAT THESE  
25 EXISTING OR PROPOSED AFFILIATE RESTRICTIONS AND THE  
26 CORRESPONDING DEGREE OF "REGULATORY INSULATION" FOR  
APS ARE INADEQUATE?

1 A. No, quite the contrary. It is because of these various affiliate limitations that  
2 APS must come to this Commission and prove that a specific transaction or  
3 activity covered by the aforementioned restrictions is nonetheless compatible  
4 with the interests of APS and its customers. We proved this in Decision No.  
5 65434 and have done so again in this proceeding. APS also comes to this  
6 Application out of the truly unique circumstances of Decision No. 65154, which  
7 recognized the changes in the wholesale electric market prompting, in turn, the  
8 Commission's "change of course" regarding divestiture. These are the  
9 distinguishing facts that some rating agency analysts fail to grasp. They  
10 sometimes fall into the trap of believing that having rigid sets of "one size fits  
11 all" regulations and rules can substitute for the informed judgment of local  
12 utility regulators.

13 Yet another practical example of "regulatory insulation" is the "self-help"  
14 program initiated by PWCC to address the remaining portion of the Bridge Debt  
15 problem described in the Company's Application and testimony. We recently  
16 issued PWCC common stock to the degree our financial people believed  
17 prudent. PWCC and PWEC are cutting and deferring expenses and capital  
18 outlays, such as the recent cancellation of Redhawk Units 3 and 4. Another non-  
19 APS affiliate, SunCor, is accelerating its sales of real estate to increase cash  
20 distributions to PWCC. We know that the \$500 million loan covers only a part  
21 of the Bridge Debt and that much of this Debt will simply have to be repaid by  
22 PWCC rather than refinanced.

23  
24 VI. THE STAFF'S PROPOSED DIVIDEND LIMITATION

25 Q. **HAS APS AGREED TO THE STAFF'S PROPOSED DIVIDEND**  
26 **LIMITATION?**

1 A. Assuming the Application is otherwise granted subject to conditions no more  
2 onerous than proposed by Staff, the answer is yes.

3  
4 **Q. WHY?**

5 A. The requested financing is a necessary step in what Ms. Gomez describes in her  
6 Direct testimony as "the Recovery Plan." (See Direct Testimony of Barbara M.  
7 Gomez at page 13, *et al.*) APS is willing to accept Staff's proposal because we  
8 believe that providing the Commission this additional assurance of our good  
9 faith and resolve to act in the best interest of APS and its customers will allow  
10 the Application to be granted.

11 In doing so, I must emphasize the critical importance of Staff's corollary  
12 recommendation for an expedited waiver or variance process with regard to this  
13 condition. I also agree with Ms. Gomez about the need for precision in  
14 interpreting how this provision will be implemented in practice. APS dividend  
15 limitations will not be an easy sell with PWCC investors. And as I noted above,  
16 the \$500 million loan will still leave PWCC with considerable debt. We will  
17 have to show potential investors that the limitation allows the Commission the  
18 discretion to waive or modify it under specific circumstances and that the  
19 limitation is based on solid, publicly available financial data, data which is well-  
20 understood by the market.

21 A. **DOES APS BELIEVE THAT THE COMMISSION CAN**  
22 **UNILATERALLY IMPOSE DIVIDEND LIMITATIONS ON APS?**

23 A. No. That is a power reserved to the Company's Board of Directors subject to  
24 fiduciary obligations and legislative provisions. But there is no need to argue  
25 this point again. As we did back in 1991, when Staff also proposed a dividend  
26 limitation and litigation loomed, APS and Staff have come to a settlement on

1 this matter. This agreement, subject to the provisos described in response to the  
2 preceding question, allows this issue to become an interesting but moot point for  
3 the lawyers to debate.

4  
5 VII. CONCLUSION

6 **Q. DO YOU HAVE ANY CONCLUDING REMARKS?**

7 A. Yes. I join Ms. Gomez in appreciating the efforts of Staff and Intervenor RUCO,  
8 both of which recognized the need for favorable action on the Company's  
9 Application. My testimony has pointed out the appropriateness of such action  
10 given the history behind the present circumstances facing APS and its affiliates,  
11 PWCC and PWEC. I also respond to those intervenors, and for that matter, those  
12 in the financial community who are either unaware of or choose to ignore both  
13 that history and the comprehensive scheme of "regulatory insulation" that  
14 already exists for APS at several levels. Even Staff's proposed dividend  
15 limitation can be properly viewed as a part of a larger plan to address the  
16 ultimate regulatory treatment of the PWEC assets. In Decision No. 65154, the  
17 Commission expressed its desire to act fairly with regard to the consequences of  
18 its "change of direction." (See Decision No, 65154 at page 22.) Approval of the  
19 Company's Application, subject to the conditions proposed by Staff (with the  
20 clarification or moderation discussed by Ms. Gomez) is consistent with that  
21 expression. And it will allow APS to move on to the larger issues of the 2003-  
22 2004 rate case.

23  
24 **Q. DOES THAT CONCLUDE YOUR PREFILED REBUTTAL TESTIMONY  
IN THIS PROCEEDING?**

25 A. Yes, it does.  
26

# **APPENDIX A**

### STATEMENT OF WITNESS QUALIFICATIONS

Jack E. Davis is President for Pinnacle West Capital Corporation (PWCC) and President and Chief Executive Officer for Arizona Public Service Company (APS). And is also on the Boards of PWCC and APS.

Mr. Davis attended New Mexico State University and received BS degrees in Medical Technology in 1969 and Electrical Engineering in 1973. He was then hired by APS as an Engineer in the System Planning Department. Subsequently, he has had positions as Administrator of Power Contracts, Manager of Power Contracts, Director of System Development and Power Operations, Director of Fossil Generation, Director of Transmission Systems, Vice President of Generation and Transmission, Chief Operating Officer for PWCC, President of PWCC and was promoted to Chief Executive Officer of APS in September of 2002.

Mr. Davis has served (i) as Chairman of the Western Systems Coordinating Council (WSCC) and is a member of its Board of Trustees; (ii) as Chairman on the Western Systems Power Pool; (iii) as President of Western Energy and Supply Transmission (WEST) Associates; and (iv) as a past member of the National Electric Reliability Council Board of Trustees. He is a registered Professional Engineer in the State of Arizona. He is also on the Boards of the Greater Phoenix Chamber of Commerce, Arizona Chamber of Commerce where he serves as Chairman, and presently serves as Chairman of the Arizona Theatre Company. He is a member of the Electrical Engineering Industry Advisory Committee at Arizona State University and the Downtown Phoenix Partnership.



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**REBUTTAL TESTIMONY OF BARBARA M. GOMEZ**

**On Behalf of Arizona Public Service Company**

**Docket No. E-01345A-02-0707**

**December 30, 2002**

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SCHEDULE BMG-2R.....FITCH REPORT OF DECEMBER 4, 2002

SCHEDULE BMG-3R.....FITCH REPORT OF DECEMBER 17, 2002

1                                    **REBUTTAL TESTIMONY OF BARBARA M. GOMEZ**  
2                                    **ON BEHALF OF ARIZONA PUBLIC SERVICE COMPANY**  
3                                    **(Docket No. E-01345A-02-0707)**

4    I.    **INTRODUCTION**

5    Q.    **PLEASE STATE YOUR NAME.**

6    A.    Barbara M. Gomez.

7  
8    Q.    **HAVE YOU PREVIOUSLY SUBMITTED DIRECT TESTIMONY IN THIS PROCEEDING?**

9    A.    Yes.

10    Q.    **WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?**

11    A.    I will respond to some of the statements and conclusions of both Utilities  
12          Division Staff ("Staff") witness John S. Thornton, Jr., and intervenor Panda Gila  
13          River, L. P. ("Panda/TECO") witness Susan Abbott. I will also discuss the  
14          various conditions Staff would impose on the Arizona Corporation  
15          Commission's ("Commission") approval of Arizona Public Service Company's  
16          ("APS" or "Company") Application.

17  
18    II.    **SUMMARY**

19    Q.    **WOULD YOU PLEASE SUMMARIZE YOUR TESTIMONY?**

20          APS is greatly encouraged by the fact that both Staff and the Residential Utility  
21          Consumer Office ("RUCO") have recommended approval of the Company's  
22          Application. They recognize in their positive recommendations, as do I, that  
23          further deterioration of the financial condition of the Company's parent  
24          company, Pinnacle West Capital Corporation ("PWCC"), would have a negative  
25          impact on APS. Such continued deterioration would also threaten the ability of  
26

1 PWCC and Pinnacle West Energy Corporation ("PWEC") to retain control over  
2 the PWEC assets used to serve APS. This, in turn, could limit the Commission's  
3 ability to consider the inclusion of these generating assets in the Company's  
4 rates during the 2003-2004 APS general rate proceeding. This potential rate  
5 treatment also appears to be supported by RUCO in its testimony.

6 The conditions proposed by Staff are intended to protect APS and APS  
7 customers from any potential negative impact from the financing itself.  
8 Although APS does not believe these conditions are necessary, it is willing to  
9 accept them. I will seek to clarify Staff's "Condition No. 7" limiting APS  
10 dividends under specified circumstances and will offer an alternative estimate of  
11 the interest rate "risk premium" that Mr. Thornton is attempting to measure in  
12 Staff's "Condition No. 3."

13  
14 As much as I agree with Mr. Thornton's conclusions about the need for  
15 approving the Application, I do not share all of his views concerning the impact  
16 of the proposed financing on APS, the purpose for which that financing is  
17 necessary, or the nature of the APS/PWCC relationship. I therefore provide the  
18 Commission with additional and updated information that supports the  
19 reasonableness of Mr. Thornton's ultimate recommendation to approve the  
20 proposed financing.

21 On the other hand, Ms. Abbott's conclusions are not only unsupported by her  
22 analysis, they are flatly contrary to the available evidence. They also do not take  
23 into consideration the impact of the strict conditions Staff has proposed for the  
24 financing, which conditions largely moot Ms. Abbott's concerns. Finally, as is  
25 discussed more directly in APS President Jack E. Davis' Rebuttal Testimony,  
26

1 Ms. Abbott's presentation fails to recognize or account for the regulatory history  
2 leading to the present financial circumstances in which APS and its affiliates  
3 now find themselves.  
4

5 **III. RESPONSE TO STAFF**

6 ***I. Staff's Conditions***

7 **Q. WHAT CONDITIONS HAS STAFF RECOMMENDED BE ATTACHED**  
8 **TO THE COMMISSION'S APPROVAL OF THE COMPANY'S**  
9 **FINANCING APPLICATION?**

10 **A.** These are discussed at pages 11 and 12 of Mr. Thornton's testimony. The  
11 conditions include:

- 12 1. the debt be limited to no more than \$500 million in addition to  
13 the Company's existing debt authorization (referred to in my  
14 testimony and the Application as "Continuing Debt");
- 15 2. the note from PWEC to APS should be callable and secured in  
16 in the same manner as required by the Commission in  
17 Decision No. 65434 (December 3, 2002);
- 18 3. the PWEC note should bear a premium of 264 basis points  
19 over an APS secured note for an equivalent term;
- 20 4. the difference between the PWEC note's interest income to  
21 APS and the interest expense incurred by APS on what the  
22 APS Application calls the "Recapitalization Debt" should be  
23 recorded as a deferred credit, bearing 6% interest, which  
24 would be reflected in the Company's next rate case;
- 25 5. the PWEC note should not exceed four years without  
26 Commission approval;
6. any demonstrable increase in the APS cost of capital  
attributable to the transaction between APS and PWEC would  
be excluded from consideration in future APS rate cases; and,

- 1                   7.     APS would maintain a minimum equity ratio of 40% and  
2                   could not pay a dividend without Commission approval if its  
3                   common equity ratio would be reduced below such threshold.  
4                   APS requests for such Commission approval would be ruled  
5                   upon within 60 days, during which time the dividend  
6                   limitation would be suspended.

7                   Although not listed as a condition, Staff has also recommended that the  
8                   requested authority to issue a guarantee to PWEC or PWCC be denied, as well as  
9                   Company's alternative request to directly lend \$500 million to PWCC to directly  
10                  retire the Bridge Debt.

11               **Q.     WHAT IS THE COMPANY'S POSITION ON THESE CONDITIONS?**

12              A.     APS can generally accept Staff's conditions if the Commission otherwise  
13                      approves the Company's Application. I have added the qualifier "generally"  
14                      because Condition No. 7 requires some clarification and Condition No. 3 should  
15                      be modified to reflect a more appropriate "risk premium" for the PWEC note to  
16                      APS. And because some of these conditions are very strict (even onerous), our  
17                      acceptance of them, though conditional, requires some explanation.

18              Condition No. 1:     This is consistent with the Company's original request.

19              Condition No. 2:     Whether the PWEC note would be callable was not  
20                      addressed in the Application, but APS certainly has no objection to having that  
21                      feature added. APS likewise had not proposed to secure the PWEC note unless  
22                      APS itself issued secured debt, a most unlikely event. Our thinking was to  
23                      preserve at least the possibility of PWEC issuing additional debt on its own  
24                      using the PWEC assets as security. Because APS now intends to present its  
25                      arguments for rate-basing these PWEC assets in the 2003-2004 rate proceeding,  
26

1 such future PWEC debt may be unnecessary, and thus APS is amenable to  
2 securing the PWEC note with these assets.

3 Condition No. 3: The general concept of charging PWEC or PWCC a  
4 premium for the loan from APS is acceptable to APS so long such premium is  
5 reasonable and does not become punitive. It should be kept in mind that absent  
6 the Commission's blocking divestiture in Decision No. 65154 (September 10,  
7 2002), PWEC would have had a BBB debt rating, roughly comparable to that of  
8 APS or at worst, just a notch below. I estimate that this would translate into a  
9 risk differential of no more than 150 basis points rather than the 264 basis points  
10 suggested by Staff. Similarly, if the loan were made to PWCC (an option  
11 requested in the Application but rejected by Staff without explanation) rather  
12 than to PWEC, it would suggest approximately the same reduced risk premium.  
13 (See Direct Testimony of Barbara M. Gomez at Schedule BMG-1.)

14  
15 Condition No. 4: APS accepts this condition as consistent with both Decision  
16 No. 65434 and the recovery of deferred transition costs pursuant to the 1999  
17 APS Settlement and Decision No. 65154.

18 Condition No. 5: The suggested shorter term of the PWEC note would have  
19 been more troublesome but for the decision of the Company to seek rate base  
20 treatment of the PWEC assets subject to the usual conditions to such treatment  
21 under traditional cost-of-service regulation. With that background and the  
22 corresponding ability to ask the Commission to extend the term of the PWEC  
23 note, APS can agree to this condition.

24  
25 Condition No. 6: APS will likewise agree to this condition and believes that  
26 no such demonstrable increase in its cost of capital will occur. Indeed, this belief

1 is consistent with both Mr. Thornton's and my own conclusion that approval of  
2 the Application will actually protect the Company's credit. However, APS does  
3 not agree to forego recovery of its increased capital costs in the event its  
4 Application is denied or is approved with additional or more onerous conditions  
5 that themselves cause the Company's cost of capital to increase.

6 Condition No. 7: A regulator-imposed dividend limitation is an unusual  
7 interference with the authority of APS' Board of Directors under any  
8 circumstances. In this instance, however, the Company will voluntarily agree to  
9 Staff's proposed limitation as a condition to the approval of the Application,  
10 similar to the voluntary limitation it agreed to under the 1991 Settlement  
11 approved in Decision No. 57649 (December 6, 1991). APS has worked within  
12 the confines of such limitations in the past and can do so now so long as Staff's  
13 proposed waiver procedure is also adopted.

14  
15 However, APS would ask that the Commission clarify the 40% equity ratio  
16 limitation. By defining this calculation of common equity ratio now, it will  
17 avoid the potential for uncertainty surrounding the ability of APS to declare  
18 dividends in the future. The Company would calculate that equity ratio on a  
19 quarterly basis using its 10 Q or 10 K filings with the Securities and Exchange  
20 Commission ("SEC"). Using the reported APS balance sheet amounts, one  
21 would divide the APS common equity by the sum of such common equity and  
22 APS long-term debt (including current maturities of such debt), again as  
23 reported in the 10 Q or 10 K.

24 **Q. WHAT ABOUT THE STAFF RECOMMENDATIONS CONCERNING**  
25 **THE PROPOSED GUARANTEE OR THE POTENTIAL FOR A LOAN**  
26 **TO PWCC IN LIEU OF ONE TO PWEC?**



1 A. APS had originally proposed the guarantee option because of its potentially  
2 reduced impact on APS and because it might provide PWEC some "credit  
3 exposure" in the market that would be valuable in the future. Given the  
4 continuing challenges in the financial markets since the time the Application  
5 was filed, the guarantee option is more or less moot.

6 The direct loan to PWCC option was proposed to offer an alternative that might  
7 be less costly overall. Mr. Thornton does not give any reason why he has  
8 rejected that option, but APS will not pursue this option further if it is not  
9 penalized for that forbearance in determining the amount of the interest  
10 premium charged by APS to PWEC—an issue discussed earlier in my Rebuttal  
11 Testimony.

12 *2. The Impact of the Loan on APS*

13 **Q. DO YOU AGREE WITH STAFF WITNESS THORNTON THAT**  
14 **APPROVAL OF THE APPLICATION WILL SUPPORT APS' CREDIT?**

15 A. Absolutely. In fact, Mr. Thornton states this no less than three times in his  
16 testimony. (See Testimony of John S. Thornton, Jr., at page. 4, lines 6-7 and 15,  
17 and also at page 5, line 19.) This benefit alone satisfies the requirement that the  
18 Application be in the public interest.

19 **Q. IS THE APPLICATION CONSISTENT WITH SOUND FINANCIAL**  
20 **PRACTICES?**

21 A. Yes. As I explain in my Direct Testimony, it is a sound financial practice to  
22 avoid a known and immediate threat to one's credit rating. PWCC's financial  
23 peril poses precisely such a known and immediate threat. It is also a sound  
24 financial practice to preserve the financial viability of assets used to serve APS  
25 customers. I would note that all of the Company's major generating projects  
26

1 required APS financial and credit support prior to such generation being  
2 included in the Company's rate base. In the case of Palo Verde Unit 3, such  
3 credit support lasted almost a decade prior to the plant's eventual rate base  
4 recognition. And with the Staff conditions, APS may actually "profit" from the  
5 transaction, albeit at the expense of PWCC shareholders—a profit that will go  
6 directly to the benefit of our customers.

7 **Q. DOES MR. THORNTON ALSO AGREE?**

8 A. Mr. Thornton arrives at this same conclusion, although a portion of his  
9 testimony could be read as qualifying that support despite his evident belief that  
10 the refinancing at APS of the Bridge Debt will help to preserve the Company's  
11 own credit. For that reason, I would like to add some context to Mr. Thornton's  
12 remarks.

13  
14 At page 4, line 27 through page 5, line 3, Mr. Thornton states:

15 ...it is not necessarily a sound financial practice for APS to use its  
16 bonding capacity (the extent to which APS can issue secured debt)  
17 for the purpose of purely investing in an affiliate without any  
18 business purpose consistent with APS' primary mission. [Emphasis  
19 added.]

20 I have several comments about the preceding statement.

21 First, APS does not intend to use any of its bonding capacity in issuing the  
22 Recapitalization Debt. Even if it were, APS has far more capacity under its  
23 mortgage indenture to issue first mortgage bonds (over \$3 billion) than the debt  
24 authority requested in the Application.

25 Second, APS is not "purely investing in an affiliate." APS is attempting both to  
26 preserve its own credit rating and at least partially address the circumstances

1 created by the Commission decision not to allow the divestiture of APS  
2 generation to PWEC. It is also attempting to preserve the opportunity for  
3 Commission rate review of the PWEC assets.

4 Third, the business purpose for the proposed loan is entirely "consistent with  
5 APS' primary mission." As is discussed in Mr. Davis' Rebuttal Testimony,  
6 PWEC assets were built to serve APS customers. They already have provided  
7 literally billions of kWh to APS and were critical to maintaining reliable service  
8 during 2001 and 2002. In a very real sense, these assets are no different from  
9 APS generating assets such as Palo Verde Unit 3 that have provided power to  
10 APS customers and enjoyed APS credit support for very significant periods prior  
11 to being placed into the Company's rate base.

12  
13 I do agree with Mr. Thornton's observation that the "debt and the assets should  
14 normally be held by the same enterprise." (Testimony of John S. Thornton, Jr.,  
15 at page 6, line 19.) This will, of course, be accomplished if the Company is able  
16 to place the collateralized PWEC assets into its rates.

17 **Q. WILL APS HAVE AN APPROPRIATE DEBT/EQUITY RATIO AFTER**  
18 **ISSUANCE OF THE RECAPITALIZATION DEBT?**

19 **A.** Yes. Both Mr. Thornton and I agree on this point, which is yet another reason  
20 why the Application is in the public interest, consistent with sound financial  
21 practice and consistent with the Company's responsibilities as a public service  
22 corporation. (See Testimony of John S. Thornton, Jr., at page 13, lines 16-22.)  
23 Thus, there is no reason to believe that the proposed financing will leave APS in  
24 an overly leveraged position.

1 **Q. DOES APS HAVE LARGE NEEDS FOR ADDITIONAL DEBT CAPITAL**  
2 **FOR ITS DISTRIBUTION AND TRANSMISSION SYSTEMS, WHICH**  
3 **NEEDS WILL COMPETE IN SOME FASHION WITH ISSUANCE OF**  
4 **THE RECAPITALIZATION DEBT?**

5 A. No. Mr. Thornton expresses this concern at several parts of his testimony. (See  
6 Testimony of John S. Thornton, Jr., at page 1, lines 22-24; page 4, lines 11-12;  
7 and page 5, lines 22-26.) But in fact, APS can finance its distribution and  
8 transmission capital budgets, as well as the APS generation capital budget,  
9 entirely from internally generated funds during the expected four-year term of  
10 the PWEC note. The Company does have to refinance significant amounts of its  
11 existing debt in the future, but again that does not require incrementally  
12 increased debt levels during this period.

13 **Q. ARE THERE OTHER ADVANTAGES TO APS FROM THE PROPOSED**  
14 **FINANCING THAT ARE NOT IDENTIFIED BY STAFF?**

15 A. Yes. My Direct Testimony notes that PWEC's continued viability provides a  
16 competitive check on the merchant generators. The proposed financing will  
17 eliminate the potential for PWEC having to sell the assets presently serving APS  
18 and will allow the Commission to consider their ultimate rate treatment in the  
19 Company's next general rate case.

20 **3. *Source of PWCC's and PWEC's Present Financing Problems and***  
21 ***Other Specific Staff Criticisms of My Direct Testimony***

22 **Q. MR. THORNTON STATES THAT PWEC'S SITUATION IS NEITHER**  
23 **UNIQUE NOR ATTRIBUTABLE TO COMMISSION ACTIONS. DO**  
24 **YOU AGREE?**

25 A. No. PWEC's difficulty in obtaining permanent financing admittedly is not  
26 unique under current market conditions, but the circumstances leading to that  
difficulty are, in this specific instance, quite unique. PWEC would have been  
capable of doing its own financing at investment-grade rates once divestiture

1 was completed by year-end 2002. That divestiture of APS generation had been  
2 authorized in the 1999 APS Settlement and required by the Electric  
3 Competition Rules, and was the event upon which PWEC's credit rating quite  
4 literally depended. Thus, as I testified in my Direct Testimony, granting the  
5 financing relief requested still leaves APS, PWCC and PWEC worse off than  
6 they were before divestiture was stopped, even before imposition of the Staff's  
7 proposed conditions.

8 Mr. Thornton cites a Standard & Poor's ("S&P") Report discussing the  
9 problems of merchant generation as support for his belief that the present  
10 situation is not unique. (See Testimony of John S. Thornton, Jr., at page 3 and  
11 at Schedules JST-5 through JST-8.) But as is discussed in Mr. Davis' Rebuttal  
12 Testimony, PWEC is not just another merchant generation venture in either its  
13 origin or its purpose.

14 Mr. Thornton also argues that the Bridge Debt could have been repaid from the  
15 proceeds paid by APS for the PWEC generating assets if APS had moved to  
16 immediately acquire such assets. (See Testimony of John S. Thornton, Jr., at  
17 page 10, lines 21-22.) This ignores the fact that APS would have had to borrow  
18 the funds for that purchase, thus leaving the Company in the same or worse  
19 relative financial position as under the Application. That position would, of  
20 course, change significantly if the PWEC assets were thereafter included in the  
21 Company's rate base, but that too is no different than what APS intends to seek  
22 if the Application is granted.

23  
24 **Q. DID PWCC CHOOSE THE MATURITY OF THE BRIDGE DEBT AS**  
25 **ALLEGED BY MR. THORNTON AT PAGE 10, LINES 22-25 OF HIS**  
26 **TESTIMONY?**

1 A. Although that is literally true, it ignores the fact that the APS generating assets  
2 were to be transferred to PWEC by the end of 2002. It is no mere coincidence  
3 that most of the Bridge Debt is scheduled to mature in 2003. As I indicated in  
4 my Direct Testimony, since the Bridge Debt would cover assets that were to be  
5 owned by an operating subsidiary of PWCC (at the time, PWEC), lenders were  
6 only comfortable in lending these large sums to PWCC for a limited period of  
7 time.

8  
9 **Q. ARE PWCC AND PWEC "IMPLICITLY SUBSIDIZED" BY APS AS  
10 ALLEGED BY MR. THORNTON AT PAGE 6, LINES 4-10 OF HIS  
11 TESTIMONY?**

12 A. No, and Mr. Thornton provides no specific examples in his testimony. He states  
13 that "PWCC and PWEC are already provided a certain amount of credit support  
14 from APS through the holding company structure." (Testimony of John S.  
15 Thornton, Jr., at page 6, lines 5-6.) In fact, such credit support exists because  
16 of the holding company. There are advantages to all members of a consolidated  
17 holding company group arising from business diversity, economies of scale and  
18 scope, tax benefits, etc. These advantages are not created by any single member  
19 of the group, including APS, and then distributed to the others. They result from  
20 the synergies of the group itself and are shared by all members of the group.

21 Mr. Thornton then contends that the financial community knows that PWCC has  
22 access to APS cash flows. (*Id.* at lines 7-8.) PWCC does have access to the  
23 earnings of APS because as the sole equity investor in and owner of APS, it is  
24 entitled to such earnings in the form of dividends. I doubt owners of common  
25 stock believe they are being "subsidized," implicitly or otherwise, by receiving  
26 lawful dividends on their investment, nor has this Commission ever so found.

1 Mr. Thornton also claims that PWEC can access these same cash flows. If all he  
2 means is that PWCC can use its earnings, part of which consists of APS  
3 dividends, in any lawful fashion it chooses, including funding generation to  
4 serve APS, that is certainly no indication of "subsidization." As to direct APS  
5 assistance to PWEC, this Application is stark proof that the extent of any such  
6 assistance is largely a regulatory decision and not one unilaterally made by  
7 PWCC.

8 I also note that the allocation of common costs among the various members of  
9 the Pinnacle West organization and the pricing of inter-affiliate transactions  
10 have been either specifically approved by this Commission (as part of the  
11 Policies & Procedures that accompanied the Company's Code of Conduct under  
12 A.A.C. R14-2-1616) or approved by FERC, or by both. Thus, I do not see any  
13 basis for the contention that PWCC and PWEC are somehow improperly  
14 "subsidized" by APS.  
15

16 **Q. DID SCHEDULE BMG-3 OF YOUR DIRECT TESTIMONY INDICATE**  
17 **"THAT BORROWING \$500,000,000 FROM THE MARKET AND**  
18 **LENDING IT TO PWEC/PWCC IS A 'WASH' TRANSACTION HAVING**  
19 **NO EFFECT ON THE APS' FINANCIAL RATIOS" AS IS STATED BY**  
20 **MR. THORNTON AT PAGE 11, LINES 8-9 OF HIS TESTIMONY?**

21 **A.** No. Schedule BMG-3 shows increased financial leverage both in the debt ratio  
22 and in the "Funds from Operations" as a percent of total debt even considering  
23 the interest from the PWCC/PWEC note as operating income. I further show all  
24 credit metrics being affected using a rating agency approach that would not  
25 count interest income as operating income or "Funds from Operations." I also  
26 explain the differences between the two sets of calculations at pages 21-22 of  
my Direct Testimony. Thus, I did not state or imply in my Testimony that APS  
could lend an unlimited amount of money to PWCC/PWEC, or anyone else for

1 that matter, without impacting its credit metrics to some degree. To use Mr.  
2 Thornton's own terminology, this proposed financing is no "'wash' transaction,"  
3 but such financing is nevertheless a necessary transaction in view of the present  
4 financial market combined with the chain of events initiated by Decision No.  
5 65154.

6  
7 IV. REPOSE TO PANDA/TECO

8 Q. **MS. ABBOTT APPEARS TO HAVE GREAT CONCERN OVER THE  
9 REACTION OF STANDARD AND POOR'S AND FITCH TO THE  
10 PROPOSED FINANCING. DO YOU SHARE THAT CONCERN?**

11 A. No. Standard and Poor's ("S&P") decision on November 4, 2002 to unify the  
12 corporate credit rating of APS with that of PWCC did not affect any of the  
13 Company's specific credit ratings for secured or unsecured long-term debt nor  
14 its short-term commercial paper rating. S&P also specifically indicated that the  
15 \$500 million loan to PWEC and the additional debt incurred by APS for that  
16 purpose did not jeopardize the Company's strong BBB rating:

17 Even on a stand-alone basis, APS' financial health remains  
18 solidly within the triple-B category even with the addition of  
19 \$500 million in debt.

20 (See Schedule BMG-1R. Emphasis supplied.)

21 Fitch rates APS unsecured debt higher than S&P. Its December 4, 2002  
22 announcement did place both APS and PWCC debt securities on "Rating Watch  
23 Negative," which indicates that either or both entities could be down-rated  
24 within the next six months. But its rationale for its two actions, which is  
25 discussed both in the December 4<sup>th</sup> pronouncement and again on December 17,  
26 2002, are decidedly different. For PWCC, it is clear that refinancing the Bridge  
Debt is very troubling. Indeed, Fitch comes right out and says that if the



1 financing Application is denied, it will result in a PWCC downgrade. As to APS,  
2 Fitch has cited three factors, the increased leverage, regulatory uncertainty over  
3 the outcome of Track B, and regulatory uncertainty over the Company's next  
4 general rate case. But Fitch also notes that the increased debt leverage at APS  
5 would be, in their opinion, less of a problem if the underlying PWEC assets were  
6 moved to APS and included in rates. The two Fitch reports are attached as  
7 Schedules BMG-2R and BMG-3R.

8  
9 **Q. MS. ABBOTT PRESENTS AN "ANALYSIS" THAT INDICATES A**  
10 **HIGHER DEBT COST WHEN MOODY'S DEBT RATINGS ARE**  
11 **REDUCED TO THE SAME AS S&P'S. DO YOU AGREE WITH HER**  
12 **CONCLUSION?**

13 **A.** No. Based on her tiny sample of only five selected companies, I could not draw  
14 any meaningful conclusions. The mixing of holding companies with operating  
15 entities further obscures whatever validity the analysis would otherwise have  
16 held even assuming a larger data sample. Ms. Abbott herself concedes that this is  
17 at best "anecdotal evidence." (Testimony of Susan Abbott at page 25, line 1.)  
18 And one can just as easily construct a sample of companies "proving" precisely  
19 the opposite conclusion from that of Ms. Abbott.

20 For example, Ms. Abbott states "investors demand similar interest over  
21 Treasuries when Moody's and S&P rate issuers the same." (Testimony of Susan  
22 Abbott at page 25, lines 19-20.) Yet, Dominion Resources (one of the companies  
23 in Ms. Abbott's sample) and Constellation Energy are both rated high BBB  
24 (Baa1 and BBB+) by Moody's and S&P. But Dominion trades at 165 basis  
25 points over Treasuries while Constellation commands some 245 basis points of  
26 premium. Duke Capital and Commonwealth Edison also share the same S&P

1 and Moody's ratings (this time A- and A3), but the former trades at over 250  
2 basis points higher than the latter.

3 Ms. Abbott further contends that interest spreads are similar "when Moody's  
4 rates the issuer the same but S&P . . . rates the issuer lower than Moody's." (Id.  
5 at lines 20-22.) Such a relationship exists for both First Energy and, ironically,  
6 TECO (Baa2 by Moody's but BBB- by S&P), yet the former's spread is roughly  
7 280 basis points while TECO's is approximately 580 basis points—hardly a  
8 "similar" yield spread.  
9

10 The only conclusions one can legitimately draw from her analysis and the above  
11 exercise are: (1) if you hand-pick a small enough sample, it can show virtually  
12 anything you want it to show; and (2) investors look at far more than debt ratings  
13 in determining the collective risk premium they require for a particular  
14 enterprise. On the other hand, it would appear more logical that when there is a  
15 split in the ratings as between S&P and Moody's, the market would be  
16 conservative and price based on the lower of the two ratings, thus refuting  
17 another element of Ms. Abbott's hypothesis.

18 **Q. MS. ABBOTT ALSO PREDICTS A MOODY'S DOWNGRADE AS A**  
19 **RESULT OF THE FINANCING. HAVE YOU SEEN ANY EVIDENCE TO**  
20 **SUPPORT SUCH A CONCLUSION?**

21 **A.** No. I find it most significant that Moody's has been publicly silent on the  
22 Application. I am routinely in contact with Moody's, and I feel confident that  
23 Moody's will not drop our current ratings as a result of the Commission granting  
24 the Application, and our agreeing to the strict conditions imposed by Staff  
25 further diminishes an already unlikely event of that kind.  
26

1 Even Ms. Abbott's analysis shows APS is in the Baa1 range after the \$500  
2 million loan. (See Testimony of Susan Abbott at page 19, lines 11-13.) As a  
3 former Moody's employee, Ms. Abbott should know that Baa1 is, in fact, the  
4 Company's principal debt rating from Moody's and not A3, which only applies  
5 to the Company's first mortgage bonds. Given that these mortgage bonds are  
6 already heavily over-collateralized (see S&P Report dated November 4, 2002,  
7 which is attached as Schedule BMG-1R) it is highly unlikely that they would be  
8 impacted by \$500 million of unsecured debt. Moreover, it is possible for the  
9 Company to eliminate all of its first mortgage bonds mature by early 2004, and  
10 no new secured debt is contemplated prior to that time.

11 **Q. COULD THERE BE NEGATIVE IMPACTS TO APS IF THE**  
12 **FINANCING IS DENIED?**

13 **A.** Yes. I explain these in my Direct Testimony. Ms. Abbott does not refute the real  
14 possibility of such negative impacts, which both Staff and RUCO acknowledge.  
15 She simply ignores it in her testimony despite the fact that these adverse impacts  
16 are far more likely to occur than those hypothesized in her testimony.

17 **Q. DO THE VARIOUS CONDITIONS RECOMMENDED BY STAFF AND**  
18 **LARGELY AGREED TO BY THE COMPANY MOOT MS. ABBOTT'S**  
19 **CONCERNS THAT THE FINANCING COULD SOMEHOW HURT APS**  
**CUSTOMERS?**

20 **A.** Yes. They address both the potentially increased risk of the financing itself,  
21 turning it into an asset for the benefit of customers, and the remote possibility of  
22 the loan directly affecting APS' cost of capital in the manner hypothesized by  
23 Ms. Abbott in her testimony.

24 **Q. MS. ABBOTT CONTENDS THAT REFINANCING THE BRIDGE DEBT**  
25 **AT PWCC IS A POSSIBILITY, ALBEIT AT A COST. DO YOU AGREE?**  
26

1 A. No. Ms. Abbott cites no proof for these statements at pages 3, line 19 and 4, line  
2 8 of her testimony. They also ignore the fact that one of the goals of myself,  
3 Staff witness Thornton, and RUCO are to avoid further down-ratings at  
4 PWCC—hardly consistent with Ms. Abbott’s “borrow at any cost” alternative.  
5 My own experience in marketing the PWCC equity issuance in mid-December  
6 clearly indicated to me that PWCC’s access to the capital markets on reasonable  
7 terms is largely contingent on a favorable ruling by this Commission on the  
8 Company’s Application.

9  
10 Q. **MS. ABBOTT ALSO DISAGREES WITH YOUR OBSERVATION THAT**  
11 **THE PPA ASSUMED BY RATING AGENCIES EVALUATING PWEC**  
12 **MIGHT NOT HAVE BEEN AS ATTRACTIVE AS THE ALTERNATIVE**  
13 **OF HAVING THE PWEC ASSETS UNENCUMBERED IN THE**  
14 **MARKET (TESTIMONY OF SUSAN ABBOTT AT PAGE 28, LINES 6-**  
15 **12.) WHAT IS YOUR RESPONSE?**

16 A. Both my original observation and Ms. Abbott’s beliefs to the contrary are  
17 largely irrelevant to the unchallenged fact that PWEC did have an investment-  
18 grade credit rating premised on divestiture. But, in point of fact, neither of us  
19 will ever know for sure if we are right since there is no way to go back in time  
20 and present the alternatives to the rating agencies. I do submit, however, that a  
21 three-year PPA priced at cost between APS and PWEC, during a period when  
22 the former is under a rate moratorium and has no power cost adjustment  
23 mechanism, is not an obviously superior choice for PWEC or certainly PWCC.  
24 Faced with such a limited alternative, the unfettered ability of PWEC to sell into  
25 the competitive market could well have appeared more attractive than Ms.  
26 Abbott postulates in this portion of her testimony.

1 V. UPDATE FOR EVENTS SINCE MY OCTOBER TESTIMONY

2 Q. **WHAT EVENTS HAVE OCCURRED SINCE THE FILING OF YOUR**  
3 **OCTOBER TESTIMONY THAT YOU BELIEVE ARE RELEVANT TO**  
4 **THE COMMISSION'S CONSIDERATION OF THE APPLICATION?**

5 A. I have already discussed the S&P and Fitch actions to some extent. The other  
6 actions of significance are the Commission's granting of the Company's  
7 Emergency Application in Docket No. E-01345A-02-0840, the filing of Staff's  
8 Recommendation in this Docket, which was concurrent with the execution of the  
9 Principles for Resolution ("Principles") of Track A issues between Staff and the  
10 Company, the cancellation of Redhawk Units 3 and 4, and a new common  
11 equity issuance by PWCC.

12 Q. **WHAT WAS THE FINANCIAL MARKET REACTION TO THE**  
13 **COMMISSION'S GRANTING OF THE EMERGENCY APPLICATION**  
14 **FOR APS TO LEND UP TO \$125 MILLION TO PWCC?**

15 A. It was extremely positive. Goldman Sachs, Gerard Klauer Mattison, Merrill  
16 Lynch and others all viewed it as good news, although it is clear they are also  
17 expecting positive action by the Commission on the Company's Application in  
18 this Docket and are obviously anxious about several issues in the upcoming APS  
19 rate case.

20 Q. **DOES THAT TRANSACTION AFFECT THE PRESENT REQUEST FOR**  
21 **AUTHORITY TO BORROW AND LEND \$500 MILLION?**

22 A. The \$125 million credit line from APS to PWCC does not reduce, either  
23 qualitatively or quantitatively, the need for the longer-term \$500 million loan.  
24 However, to the extent that Decision No. 65434 relieved the market's liquidity  
25 concerns about PWCC, it may have made an APS loan to PWCC better received  
26 in the market.

1 Q. WHAT ABOUT STAFF'S RECOMMENDATION IN THIS CASE?

2 A. There was also a positive reaction to the overall recommendation. The  
3 conditions proposed by Staff received mixed reviews. Deutsche Bank indicated  
4 that they "seemed reasonable," while Lehman Brothers called them a "low water  
5 mark." Others merely noted that the conditions seemed acceptable to APS and  
6 thus should not be considered "deal killers."

7 Q. WHAT ABOUT THE OTHER ACTIONS YOU HAVE CITED?

8 A. The common equity issuance and the cancellation of the two Redhawk units  
9 were also deemed a plus. The Principles although noted, did not elicit any  
10 particularly substantive comments.  
11

12 VI. CONCLUSION

13 Q. DO YOU HAVE ANY CONCLUDING REMARKS?

14 A. APS is appreciative of the support it has received from both Staff and RUCO.  
15 Because they represent to one extent or another, APS customers in addition to  
16 the public, their conclusion that the Application should be granted, albeit with  
17 strict conditions, is especially meaningful. APS would ask that the Commission  
18 clarify the calculation of equity ratio under Condition No. 7 as discussed herein.  
19 The Commission should also modify Condition No. 3 to more properly and, just  
20 as importantly, equitably reflect the additional premium APS will collect from  
21 PWEC on account of this loan. That premium is no more than 150 basis points  
22 over a comparable secured borrowing by APS. Finally, my Rebuttal Testimony  
23 has addressed the concerns raised by both Staff witness Thornton and  
24 Panda/TECO witness Abbott. I urge the Commission to act promptly and grant  
25  
26

1 the Company's Application as requested subject to the conditions proposed by  
2 Staff.

3  
4 **Q. DOES THAT CONCLUDE YOUR PREFILED REBUTTAL TESTIMONY**  
**IN THIS PROCEEDING?**

5 **A.** Yes, it does.  
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**EXHIBIT**

**BMG – 1R**



<b>STANDARD &amp; POOR'S</b>	<b>RATINGS DIRECT</b>

## Research:

Return to Regular Format

### Arizona Public Service Co.'s Corporate Credit Rating Lowered; Parent Pinnacle Affirmed

Publication date: 04-Nov-2002

Credit Analyst: Kathryn Mock Masterson, San Francisco (1) 415-371-5009

NEW YORK (Standard & Poor's) Nov. 4, 2002--Standard & Poor's Ratings Services said today it affirmed the debt securities ratings of electric utility Arizona Public Service Co. (APS) and lowered the corporate credit rating (CCR) to triple-'B' from triple-'B'-plus. At the same time, it affirmed the triple-'B' corporate credit rating of parent Pinnacle West Capital Corp. (PWCC), and lowered its triple-'B' senior unsecured debt rating to triple-'B'-minus.

The downgrade of the APS CCR is the result of Standard and Poor's conclusion that the regulatory insulation standard is insufficient to warrant a separation of the CCRs between APS and PWCC. The triple-'B' CCR at both entities reflects the consolidated rating of the combined entity.

"This action also results in a change in the unsecured debt rating at PWCC because of the structural subordination of this debt as compared to the unsecured debt at APS since the two are viewed as a single economic entity," said Standard & Poor's credit analyst Kathryn Mock Masterson.

The senior secured rating of APS was affirmed at senior secured 'A-' due to substantial overcollateralization of the first mortgage bonds and, importantly, management's stated intent not to issue significant additional secured debt. All first mortgage bonds are callable as of March 2004, which will allow APS to retire its old 1946 master first mortgage bond indenture.

It is important to note that these rating actions are not a result of the company's proposal to move \$500 million of debt from PWCC to APS. Based on Standard & Poor's consolidated rating methodology, the movement of debt from the parent to the subsidiary does not affect the overall financial health of the entities. Even on a stand-alone basis, APS' financial health remains solidly within the triple-'B' category even with the addition of \$500 million in debt.

Complete ratings information is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at [www.ratingsdirect.com](http://www.ratingsdirect.com). All ratings affected by this rating action can be found on Standard & Poor's public Web site at [www2.standardandpoors.com](http://www2.standardandpoors.com); under Fixed Income in the left navigation bar, select Credit Ratings Actions.

**EXHIBIT**

**BMG – 2R**



Fitch :  
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Center :  
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Release

## **Fitch Ratings Places PNW & APS On Rating Watch Negative** [Ratings](#)

04 Dec 2002 3:00 PM

Fitch Ratings-New York-December 4, 2002: Fitch Ratings has placed the debt ratings of Pinnacle West Capital Corp. (PNW) and its operating utility subsidiary, Arizona Public Service Company (APS) on Rating Watch Negative. The Rating Watch affects PNW's 'BBB' senior unsecured debt 'F2' commercial paper ratings, APS's 'A-' senior secured and 'BBB+' senior unsecured debt ratings. APS's 'F2' Commercial Paper rating is affirmed by Fitch.

The Rating Watch Negative for PNW reflects concern over the company's ability to refinance \$790 million of maturing debt issued to finance power plant development at its independent power subsidiary, Pinnacle West Energy Company (PWEC), increasing exposure to merchant energy markets, and the uncertain regulatory treatment of 1,800 mw of new generation. The Negative Rating Watch for APS reflects regulatory uncertainty and the potential increase in leverage related to PNW's plan to issue debt at APS. APS recently received approval to provide a \$125 million line of credit to PNW, and has requested Arizona Corporation Commission (ACC) approval to issue \$500 million of unsecured debt (or to guarantee a similar amount) with the intent to use the proceeds to pay down maturing PNW debt. The incremental debt would be less problematic if it ultimately becomes part of the cost of transferring and rate-basing PWEC's generation at APS.

PNW's original plan to issue debt at PWEC is no longer possible due to the ACC's decision to block the transfer of APS' generating capacity to PWEC. Also affecting PNW's refinancing plan are depressed wholesale power markets, a restrictive capital market environment, and PWEC's relatively small generation portfolio (1,300 mW in operation). The planned asset transfer was in accordance with the ACC-approved electric industry restructuring settlement. The ACC's decision in Track A of its generic review of electric competition blocked the transfer of the generation assets from APS to PWEC, and was silent on the status of 1,800 mW of unregulated generation capacity built by PWEC to meet APS demand growth.

With PWEC unable to fund itself, PNW is relying on the utility to refinance the majority of the \$790 million of bridge financing debt maturing over the next 14 months through an inter-company loan. If an inter-company loan is authorized by the ACC, the proceeds will be transferred to PNW and used to reduce parent-company debt. It is unclear whether the ACC will approve the company's \$500 million financing request. Failure to obtain the inter-company loan or access alternate sources of funding would result in a downgrade of PNW.

Contact: Philip Smyth 1-212-908-0531 or Robert Hornick 1-212-908-0523, New York.

Media Relations: Matt Burkhard 1-212-908-0540, New York.

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**EXHIBIT**

**BMG – 3R**



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## **Fitch Comments On Staff Testimony In APS Financing Request** Ratings

17 Dec 2002 2:05 PM

Fitch Ratings-New York-December 17, 2002: Recent testimony filed by the staff of the Arizona Corporation Commission (ACC) supporting Arizona Public Service Company's (APS) requested financing order is positive for the credit quality of Pinnacle West Capital Corp. (PNW), according to Fitch Ratings. The financing order seeks authority to issue \$500 million of unsecured debt. Proceeds would be used to refinance maturing parent company debt incurred to fund power plant development at its non-regulated subsidiary Pinnacle West Energy Corp. (PWEC). If ultimately approved by the ACC, the financing would provide sufficient liquidity for PNW to meet debt maturities in 2003. In combination with the 'Principles of Resolution' agreed to by the Staff and APS (and discussed below), the staff testimony also lends some clarity to the regulatory process in Arizona and signals a reasonable working environment with the ACC Staff. Fitch recently placed the 'BBB' senior unsecured debt ratings of PNW on Rating Watch Negative citing concern over the company's ability to refinance \$790 million of maturing over the next 14 months, increasing exposure to merchant energy markets, and the uncertain regulatory treatment of 1,800 mw of new generation. The Rating Watch Negative at PNW could be resolved favorably if the financing order were approved by the ACC in combination with a demonstration by the company of access to capital markets at reasonable rates. The transfer of PWEC capacity to APS and its inclusion in rates would also be favorable.

The impact of the staff recommendation on APS' ratings (listed below) will depend on the ultimate treatment of the 1,800 mw of capacity currently owned by PWEC. The current Negative Rating Watch for APS reflects the potential increase in leverage related to PNW's plan to issue debt at APS and regulatory uncertainty over the company's upcoming rate case and the process for securing future power supply. In revising the Rating Watch for APS to Negative from Stable on Dec. 4, 2002, Fitch noted that increased utility debt would be less of a concern if it is part of the cost of acquiring and ultimately rate basing the 1,800 mW's of PWEC generating capacity.

On Friday, Dec. 13, 2002, the ACC Staff filed testimony supporting APS's request for authorization to issue \$500 million of unsecured debt, with the intent to use the proceeds to repay maturing PNW debt. Separately, the Staff and APS have agreed to principles for resolving certain issues raised by APS in its appeal of the Commission's Track A order. Under the resolution, APS would limit any prospective Track A appeal to the following issues, which would be appropriate for consideration by the commission in the company's 2003 base rate case: 1) the inclusion of 1,800 mW's of generation constructed by PWEC to meet APS demand growth; 2) the appropriate treatment of \$234 million of pre-tax asset write-off agreed to by APS as part of the 1999 settlement agreement; and 3) the appropriate treatment for costs incurred by APS in preparation for the transfer of generation assets to PWEC.

PNW's original plan to issue debt at PWEC is no longer possible due to the ACC's decision to block the transfer of APS' generating capacity to PWEC. Also affecting PNW's refinancing plan are depressed wholesale power markets, a restrictive capital market environment, and PWEC's relatively small generation portfolio (1,300 mW's in operation). The planned asset transfer was in accordance with the ACC-approved electric industry restructuring settlement. The ACC's decision in Track A of its generic review of electric competition blocked the transfer of the generation assets from APS to PWEC, and was silent on the status of 1,800 mW's of unregulated generation capacity built by PWEC to meet APS demand growth.

Pinnacle West Capital's ratings are as follows:

--Senior unsecured 'BBB'; and,

--Commercial paper 'F2'.

Arizona Public Service Company's ratings are as follows:

- Senior secured 'A-';
- Senior unsecured 'BBB+'; and,
- Commercial paper 'F2'.

All of APS and PNW's debt securities are on Rating Watch Negative, with the exception of APS commercial paper, which has a Stable Outlook.

Contact: Philip Smyth 1-212-908-0531 or Robert Hornick 1-212-908-0523, New York.

Media Relations: James Jockle 1-212-908-0547, New York.

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## Pinnacle West Capital Corp.

Philip W. Smyth, CFA  
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Senior Secured	Senior Unsecured	Short-Term	Watch	Last Reviewed
-	BBB	F2	Negative	12/02

## Arizona Public Service Co.

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Senior Secured	Senior Unsecured	Short-Term	Watch	Last Reviewed
A-	BBB+	F2	Negative	12/02

### ■ Outlook

The Rating Watch Negative status for PNW reflects concern regarding the company's ability to refinance \$790 million of maturing debt issued by the parent to finance power plant development at Pinnacle West Energy Corp. (PWEC). Recent testimony filed by the staff of the Arizona Corporation Commission (ACC) supporting Arizona Public Service Company's (APS's) requested financing order could resolve the refinancing risk at PNW. The financing order seeks authority to issue \$500 million of unsecured debt. Proceeds would be used to refinance maturing parent company debt incurred to fund power plant development at PNW's non-regulated subsidiary, PWEC. If ultimately approved by the ACC, the financing would provide sufficient liquidity for PNW to meet debt maturities in 2003.

At APS, the Rating Watch Negative status is due to regulatory uncertainty and the potential increase in leverage related to PNW's plan to issue debt at APS to refund maturing bridge-debt at the parent. The impact of the financing order on APS, if it is approved by the ACC, will depend on the treatment of 1,800 MWs of PWEC generating plant. The incremental APS debt would be less problematic if it ultimately becomes part of the cost of transferring and rate-basing PWEC generation at the utility. The support of the Arizona Corporation Commission (ACC) staff for APS's recent financing order along with an agreement between APS and staff regarding Track A issues appropriate for commission consideration lends some clarity to the regulatory process in Arizona and signals a reasonable working environment with the ACC staff.

### ■ What could lead to positive rating action?

- For PNW, successful execution of \$500 million inter-company loan in combination with a demonstration by the company of access to capital markets at reasonable rates.
- Alternatively, success of contingency plans to meet refinancing needs.
- For APS, ability to rate base PWEC generation to offset potential increase in debt.

### ■ What could lead to negative rating action?

- Inability of PNW to access capital markets in early-2003.
- Exclusion of PWEC capacity from utility rate base, combined with continued poor merchant market fundamentals.
- Major unscheduled nuclear outage or nuclear accident at Palo Verde.

### Gross Debt at Sept. 30, 2002:

PNW (Group):	\$3,863mil.
PNW (Parent level):	\$1,073mil.
APS:	\$2,632mil.

### Off-Balance Sheet Debt\* at Sept. 30, 2002:

PNW (Group):	c. \$406mil.
--------------	--------------

### Available Liquidity\* at Sept. 30 2002:

PNW:	c.\$278mil.
Including cash of	\$28mil.
APS:	c.\$259mil.
Including cash of	\$9mil.

### Credit Facilities Expiring in 2003:

PNW:	\$125mil. (12/03)
APS:	\$250mil. (6/03)

### Debt Maturing in 2003:

PNW: Bridge loan	\$300mil. (7/03)
	\$250mil. (8/03)
	\$25mil. (12/03)
APS:	Nil during 2003

\* Fitch calculations.

Rating action: change in Outlook, instigation of a Rating Watch or change in rating level. Revision of an Outlook from Negative to Stable, or removal from Rating Watch and instigation of a Stable Outlook would constitute positive rating action. Off-balance sheet includes leasing agreements, tolling agreements, prepayment contracts, guarantees and similar undertaking. More details can be obtained from the analyst named above.

**REBUTTAL TESTIMONY OF ARTHUR H. TILDESLEY**

Managing Director, Salomon Smith Barney Inc.

On Behalf of Arizona Public Service Company

Docket No. E-01345A-02-0707

December 30, 2002



**REBUTTAL TESTIMONY OF ARTHUR H. TILDESLEY**  
**ON BEHALF OF ARIZONA PUBLIC SERVICE COMPANY**  
**(Docket No. E-01345A-02-0707)**

**INTRODUCTION**

**Q. Please state your name, occupation, and business address.**

A. My name is Arthur H. Tildesley. I am a Managing Director of Salomon Smith Barney Inc. ("SSB"). My business address is 388 Greenwich Street, New York, New York 10013.

**Q. Have you previously submitted written direct testimony in this proceeding?**

A. Yes.

**Q. What is the purpose of your rebuttal testimony?**

A. The purpose of my testimony is to address certain points in Staff witness John S. Thornton, Jr.'s testimony, filed on December 13, 2002. More specifically, I will respond to:

- his conclusion that the potential weakening in Arizona Public Service Company's (APS) financial ratios resulting from the issuance of an additional \$500 million of debt is significant and would negatively impact the Company;
- his statement that my conclusions on the limited ability of Pinnacle West Energy Corporation (PWEC) to access financing are "speculative and unsupported by documentation;" and
- his assertion that my conclusions regarding the impact of PWEC market access on Pinnacle West Capital Corporation (PWCC) credit quality are "speculative and unsupported by documentation."

1 **SUMMARY OF CONCLUSIONS**

2 **Q. Briefly summarize your rebuttal.**

3 A. The conclusions in my testimony were backed by significant and credible evidence at the  
4 time of its filing and my testimony filed on October 11, 2002, is still valid in every  
5 respect. I also have obtained and provide further evidence from the period after October  
6 11, 2002 to support my initial conclusions.

7 **COMMENT ON THE TESTIMONY OF MR. THORNTON**

8 **Q. In your testimony filed on October 11, 2002, you state that you believe that a \$500**  
9 **million intercompany loan from APS to PWEC will not impair fundamental utility**  
10 **credit quality. Are you still of the same opinion?**

11 A. Yes, I am. As I stated in my testimony filed on October 11, 2002, our own financial  
12 analysis indicates that APS business fundamentals and credit statistics are quite strong,  
13 and that APS has sufficient credit capacity to provide an intercompany loan to PWEC in  
14 the amount of \$500 million without impairing fundamental utility credit quality. This  
15 conclusion was based on our analysis showing that APS' credit statistics pro forma for a  
16 \$500 million loan would remain within the ranges specified by S&P for a BBB rating.  
17 (Please see pp. 8-10 of my October 11, 2002 direct testimony.) Rating agencies establish  
18 such ranges and use them as only one of several factors in assessing a company's credit  
19 rating. Other factors that are taken into consideration include, but are not limited to, the  
20 quality of regulation, the quality of management and the company's competitive position.  
21 The rating agencies have made it clear that the rating process takes into account a broad  
22 analysis of business and financial risk, and that no single factor, including financial ratios,  
23 can be used to exclusively determine a credit rating.

24 **Q. In his testimony, Mr. Thornton states that he disagrees with your conclusion**  
25 **regarding the impact on APS, and that "the potential reduction in APS' financial**  
**ratios is significant and would negatively impact the Company." What is your**  
**response?**

1 A. In addition to the analysis referred to in the previous question, I would refer to a report  
2 released by Standard & Poor's (S&P) after I filed my original testimony on October 11,  
3 2002. This report directly supports the view I expressed in my testimony on the potential  
4 impact on the credit quality of APS.

5 On November 4, 2002 S&P released a report on APS that stated:

6 Based on Standard & Poor's consolidated rating methodology, the  
7 movement of debt from the parent to the subsidiary does not affect the  
8 overall financial health of the entities. *Even on a stand-alone basis,*  
9 *APS' financial health remains solidly within the 'BBB' category even*  
10 *with the addition of \$500 million in debt. ... Liquidity [at the*  
11 *consolidated entity] is adequate, but will fall to slim levels in mid-2003*  
12 *when the \$550 million comes due. The company intends to redeem this*  
13 *debt with the \$500 million issue at APS, which will be loaned to PWEC*  
14 *to repay most of the financing. Dividends from APS and SunCor in*  
15 *2003 and 2004 are expected to be sufficient to repay the remaining*  
16 *amounts. The current ratings reflect the assumption that this repayment*  
17 *will occur and that the \$500 million will be issued at APS. The stable*  
18 *outlook reflects the assumption that the ACC will approve the*  
19 *application by PWCC to issue up to \$500 million at APS to repay a*  
20 *portion of the \$750 million bridge financing at PWCC that was done to*  
21 *build assets at PWEC, as required by the 1999 settlement agreement*  
22 *with the ACC.*

23 S&P Summary Analysis – Arizona Public Service Co., November 4, 2002 (*italics*  
24 added for emphasis)

25 Q. In your original testimony, you state that "PWEC does not have access to third-party  
debt financing on a non-recourse basis in any meaningful amount." Mr. Thornton  
calls your statement "speculative and unsupported by documentation." How do you  
respond?

A. In 2003, PWEC will operate as a pure merchant generating company, meaning they have  
no long-term contracts for the sale of output or capacity from their generating facilities. I  
stated in my initial testimony that there have been no pure merchant financings in either  
the bank or bond markets since the fourth quarter of 2001, and this still remains true.  
Investors are unwilling to lend capital against merchant generation assets due to concerns  
over low wholesale power prices. The statement from S&P quoted in my initial testimony  
still holds true:

1 The overcapacity will eventually be worked down through demand  
2 growth or retirement of older, less-efficient generating units. However,  
3 in the short term, *neither of these trends will likely occur to the extent*  
4 *necessary to encourage investors to lend eagerly to this sector.*

5 S&P, Refinancing Risk in the U.S. Power Sector - The Preponderance of Mini-Perm  
6 Debt, September 6, 2002 (*italics added for emphasis*)

7 Furthermore, I would like to point to a recent report from Fitch Ratings (Fitch),  
8 which was released on December 17, 2002, in response to the filing of  
9 testimony by the staff of the ACC. In this report, Fitch writes:

10 *"PNW's original plan to issue debt at PWEC is no longer possible due*  
11 *to the ACC's decision to block the transfer of APS' generating capacity*  
12 *to PWEC. Also affecting PNW's refinancing plan are depressed*  
13 *wholesale power markets, a restrictive capital market environment, and*  
14 *PWEC's relatively small generation portfolio (1,300 MWs in*  
15 *operation)."*

16 Fitch Ratings Comments on Staff Testimony in APS Financing Request, December 17,  
17 2002 (*italics added for emphasis*)

18 **Q. Has Mr. Thornton offered any evidence of his own that PWEC could currently**  
19 **access capital markets in any meaningful fashion?**

20 **A.** No.

21 **Q. Has there been any change in the financial markets since you filed your original**  
22 **testimony that would make you reconsider your statement regarding the lack of**  
23 **access to the capital markets for PWEC on a standalone basis?**

24 **A.** No, there has not. There have been no new financings in the bank or public bond markets  
25 of pure merchant generating assets since I filed my original testimony. In addition, the  
outstanding debt of the companies whose business is predominantly merchant generation  
continues to trade at credit spreads indicating that new issuance would not be possible.

1 **Q. In his testimony, Mr. Thornton points out that your statement regarding the lack of**  
2 **access to the capital markets for PWECC on a standalone basis "was not supported by**  
3 **any documentation of PWECC efforts to raise significant debt financing." Is it**  
4 **"speculative" to come to a conclusion on this topic without actually having tried to**  
5 **raise financing at PWECC?**

6 **A.** No, it is not. An important part of the work we do at Salomon Smith Barney is related to  
7 assessing the feasibility of potential financing transactions and the rate at which we  
8 believe any financing will price once it is launched. This work is performed routinely  
9 throughout our institution and for a wide variety of clients and types of financings. We  
10 are the largest underwriter of debt securities in the world having raised over \$429 billion  
11 in 2001, and more specifically, we are the largest underwriter of investment grade debt  
12 securities in the U.S. power sector, raising nearly \$15 billion in 2001. We also  
13 consistently rank as the number one or two arranger of syndicated bank loans to the U.S.  
14 power sector. As such, we are well-positioned to be able to evaluate the market appetite  
15 for different issuers and types of securities.

16 In addition, prospective borrowers do not normally test the credit markets to find out  
17 whether they can borrow funds on commercially reasonable terms. The cost of a failed  
18 issuance can be extremely high in terms of future financial credibility, and prudent  
19 borrowers do not attempt to secure financing unless there is a high probability of success.

20 **Q. In your original testimony you conclude that the credit quality of PWCC might**  
21 **suffer if PWECC is not able to obtain new debt financing on a standalone or non-**  
22 **recourse basis. In his testimony Mr. Thornton calls this statement "speculative and**  
23 **unsupported by documentation." What is your response to Mr. Thornton's**  
24 **comments?**

25 **A.** As I stated in my original testimony, I believe that the inability of PWECC to fund on a  
standalone or non-recourse basis in the bank loan or public debt markets may have

1 adverse credit consequences for PWCC. This view was supported among other things by  
2 the following statement from Moody's:

3 The rating outlook [for PWCC] is stable and *assumes the Pinnacle*  
4 *bridge financing is refinanced at an operating subsidiary in the*  
5 *intermediate term. Failure to do so could have negative rating*  
6 *implications.*

Moody's Opinion Update on PWCC, September 9, 2002 (*italics added for emphasis*)

7 **Q. Does this conclude your written rebuttal testimony in this proceeding?**

8 **A. Yes, it does.**